Volatile markets create Roth IRA conversion opportunities

As stocks dip this year, some investors are taking advantage of the market volatility by converting their traditional pre-tax IRAs to a Roth IRA. Why? Because the decline in the current market value of the Traditional IRA means a reduced tax liability upon conversion

How a Roth IRA works

Roth IRAs are similar to traditional IRAs except that Roth contributions are “after-tax,” which means you pay taxes on your contribution upfront. Consequently, withdrawals from Roth IRAs are tax-free, meaning that your investment earnings and growth are never taxed. Traditional pre-tax IRA contributions are not taxed upfront, so they can help you reduce your current taxable income, and are taxed when you take a distribution from the account. Depending on your situation, a Roth may create significant value for you and your heirs.

Unfortunately, high earners often assume they are ineligible for a Roth IRA, but this is not necessarily true. Even though you may not be eligible to contribute directly to a Roth IRA, you may be able to convert a traditional pre-tax IRA into a Roth IRA.

Generally, only taxpayers with income below certain levels may contribute to a Roth IRA. In 2022, individuals with income less than $144,000 and married couples filing jointly with income of $214,000 or less are eligible.[1]

Key advantages of a Roth IRA

- The ability to withdraw money tax-free, including the earnings. This appeals to anyone who wants to minimize their tax bite in retirement or believes that taxes will be higher later than they are now.
- There are no annual required distributions from a Roth IRA (as there are for a traditional IRA).
- The ability for wealthier taxpayers to maximize assets and minimize taxes for their heirs. A spouse inheriting their partner’s Roth is not required to take mandatory distributions, while non-spouse beneficiaries must take distributions within the first ten years after the original owner's death. In either case, all distributions are withdrawn tax free.

How to convert to a Roth IRA

All taxpayers, regardless of income, can convert some or all of their traditional pre-tax IRAs to a Roth IRA. During a “Roth conversion,” you elect to pay income taxes now on a portion of your pre-tax accounts. These amounts are then transferred into a Roth IRA account, where they are treated as a regular after-tax Roth IRA. Additionally, during a Roth conversion, income taxes are only calculated on the pre-tax conversion amount. Non-deductible “basis” is not included in the tax calculation, and there are no additional penalties for those younger than 59½.

Why now might be a good time for a Roth

This strategy may be particularly valuable in today’s market conditions. In difficult economic periods, such as the current volatile market, the value of your pre-tax traditional IRA may have declined. By converting a portion of this account to a Roth, you may pay taxes on a smaller market value. As your portfolio recovers, the Roth IRA and all future growth will be forever tax-free.

Today’s market volatility presents the perfect time to discuss whether converting your traditional IRA to a Roth makes sense based on your unique circumstances. We can discuss eligibility requirements, the pros and cons of a conversion, and the potential benefits of a Roth IRA for intergenerational wealth transfer.

As always, please reach out to your wealth advisor if we can assist with your understanding of whether a Roth might make sense for you when viewed as part of your overall long-term financial plan.

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